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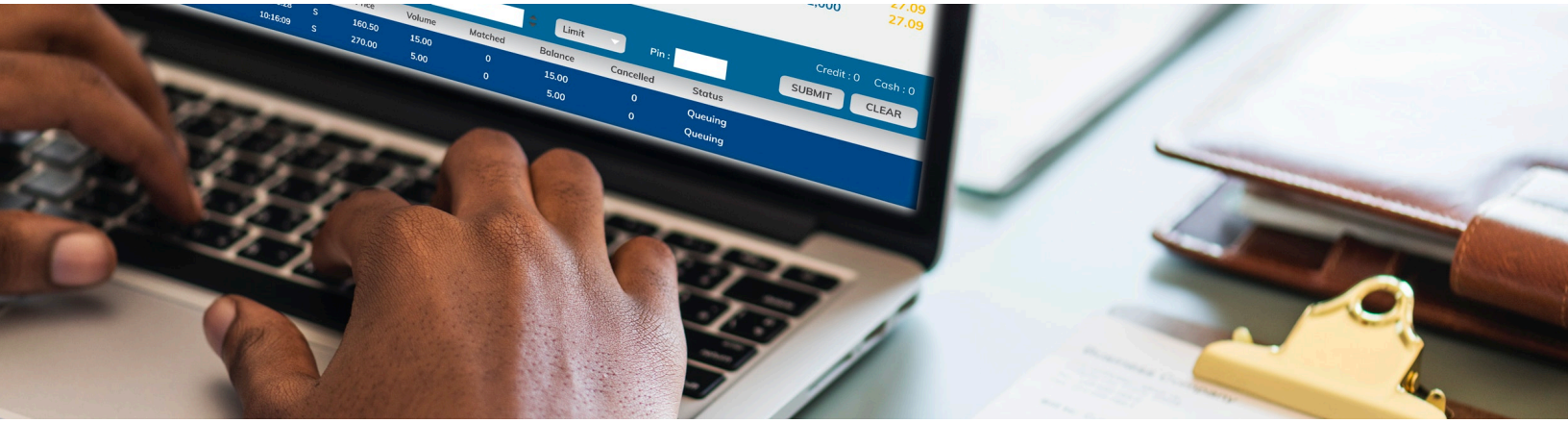

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The Real Economy 69

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THE REAL ECONOMY

VOLUME 69

SMALL AND MEDIUM-SIZE FIRMS IN CRISIS

MAJOR POLICY SHIFT AT THE FEDERAL RESERVE: AVERAGE INFLATION TARGETING

HOTEL OCCUPANCY DATA: IT'S ONLY HALF THE STORY

INDUSTRY SPOTLIGHT: MORE PROMISE, MORE PROBLEMS FOR LIFE SCIENCES

MIDDLE MARKET TREND WATCH: REOPENING CONSIDERATIONS

THE POWER OF BEING UNDERSTOOD
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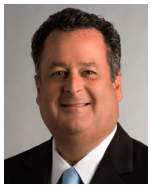
Our thought leaders are professionals with years of experience in their fields who strive to help you and your business succeed. Contributors to this issue include:



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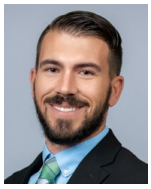

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SMALL AND MEDIUM-SIZE FIRMS IN CRISIS

A MESSAGE FROM THE REAL ECONOMY

BY JOSEPH BRUSUELAS

THE CONDITION of small and medium-size firms implies a potential inflection point in the nascent economic rebound following the near shutdown of the economy last spring. Without further reform and support of the signature Paycheck Protection Program—which provided a vital lifeline to those firms during the worst of the pandemic—there will be an increase in bankruptcies, followed by another round of job losses, this time tilted toward the permanent elimination of jobs that support the bulk of the American middle and working classes.

With many of these businesses still struggling to survive, almost all of the PPP loans made to small and midsize firms will have to be forgiven to prevent a much larger round of permanent job losses. Since the onset of the crisis, we have made the case that roughly one quarter of the jobs lost during the initial part of the pandemic would be permanent. Recent data surveying small and middle market firms indicates that forecast may be somewhat optimistic. Moreover, the risk tolerance of the U.S. Treasury is going to have to increase in order for businesses to better utilize not only a replenished PPP, but also the $600 billion sitting on account at an underutilized Main Street Lending Program.

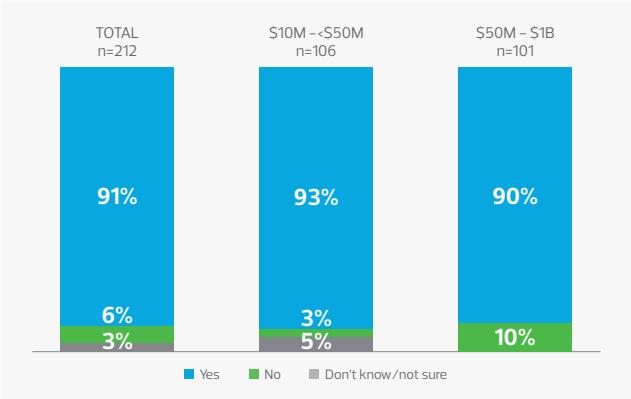
Further aid needed

Much of the focus around the current policy impasse around a potential fifth round of fiscal aid has been on the status of the unemployed and the roughly $15 billion per week they stopped receiving on July 31. That is understandable, given the 28 million individuals on some form of unemployment insurance through mid-August, the millions more who have exhausted their state

and pandemic emergency assistance, and the median duration of unemployment standing at 15 weeks. Yet the condition of the small and middle market firms that comprise the majority of the real economy is such that they will almost certainly need further aid and significant policy liberalization of the PPP and MSLP going forward.

Recent data culled from our proprietary RSM US Middle Market Business Index and the National Federation of Independent Business point to an increase in bankruptcies and unemployment later this year that will cause the aforementioned labor market dynamics to shift in a negative fashion and feature permanent job losses.

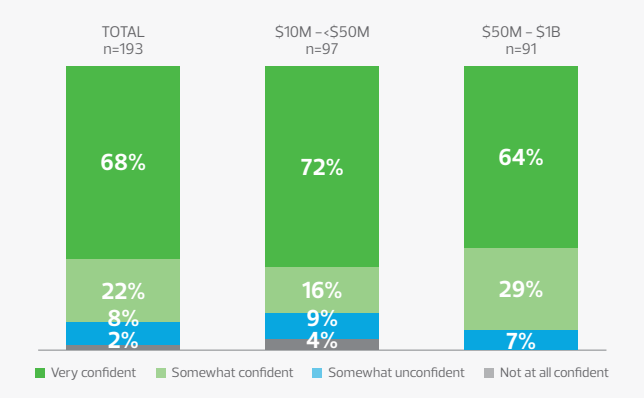
Organization received loan proceeds for PPP



Source: RSM US Middle Market Business Index survey, Q3 2020

Roughly 91% of respondents in the July MMBI survey indicated that they had received a PPP loan, and that same metric said they planned to ask for forgiveness of those loans. However, only 68% expressed a high degree of confidence that those loans would be forgiven.

Confidence that organization will be successful in achieving forgiveness for PPP loan



Source: RSM US Middle Market Business Index survey, Q3 2020

That imbalance is at the core of the growing risks to the economic outlook inside the real economy. With national consumption down 4.4% overall from January to Aug. 9, 2020, and with the expiration on July 31 of $60 billion per month of unemployment insurance that has boosted spending among low income groups by 1.1%, one gets the sense that the sound and fury from small and midsize enterprises will multiply at a geometric rate this fall.

An existential crisis

A recent NFIB survey of 20,000 small firms conducted on Aug. 17–18 indicated that reduced revenues, fixed costs and an impaired economy have created the conditions where risks to long-run sustainability are rising. According to the survey, 21% of small firms indicate they will have to close their doors if the economy does not improve over the next six months, and another 19% indicate they will do the same over the next seven to 12 months if the economic status quo does not change for the better.

In short, with roughly 40% of small firms facing an existential crisis and 32% of midsize firms expecting the initial round of PPP loans will not be forgiven, economic conditions inside the real economy are not improving to the point where the overall economy will be able to generate enough momentum to achieve escape velocity from recession gravity, absent further aid from the federal government. ■

MIDDLE MARKET INSIGHT

With many of these businesses still struggling to survive, almost all of the PPP loans made to small and midsize firms will have to be forgiven to prevent a much larger round of permanent job losses.

MAJOR POLICY SHIFT AT THE FEDERAL RESERVE: AVERAGE INFLATION TARGETING

BY JOSEPH BRUSUELAS

FEDERAL RESERVE Chairman Jerome Powell on Aug. 27 announced a significant shift in the central bank policy regime that moves away from its long held Phillips curve-based tradeoff between employment and inflation. This will provide the Federal Reserve more room for accommodation in an era of zero interest rate policy and position the central bank to support maximum sustainable employment without running the risk of higher inflation expectations and actual inflation. While this may seem a small technical adjustment to policy, it carries significant consequences for the American economy in the long run.

This shift in policy is driven by long-term changes to the underlying structure of the economy toward slower growth, a reduction in the neutral rate of interest (what economists refer to as r*), and the understanding that the economy can generate much lower unemployment without running the risk of higher inflation.

The neutral rate of interest

MONETARY POLICY IS NEITHER CONTRACTIONARY OR EXPANSIONARY

Source: RSM US LLP

Under the new framework, the Fed will no longer move in anticipation of higher inflation associated with lower unemployment around its 2% inflation target. Rather, the Fed will now let the economy run "hot" and inflation rise above its 2% target for a time without risking the anchoring of inflation expectations. Thus, if policy variable-core personal consumption expenditures inflation runs at 1.5% over a five-year period, the Fed would be quite comfortable permitting inflation to run at a 2.5% rate over the next five years without running any risk to its target.

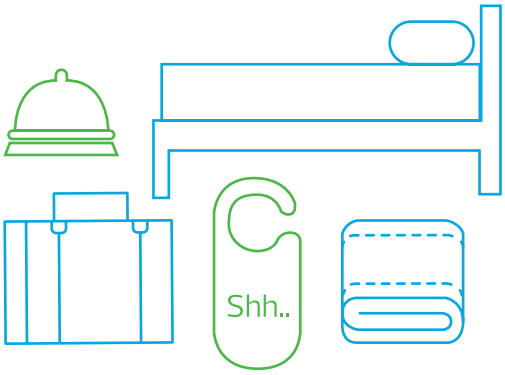
In some ways, this encapsulates and institutionalizes former Fed Chair Ben Bernanke's flexible inflation targeting regime and former Fed Chair Janet Yellen's lower-for-longer interest rate policy. It is the logical next step in the evolution of monetary policy. Moreover, it gives the central bank a tremendous amount of flexibility to respond to exigent circumstances such as a massive second wave of the pandemic next winter or to address another policy fail by the fiscal authority if the current polarization in Washington, D.C., endures.

In our estimation, the new intertemporal policy framework is a much needed regime change that is appropriate given the structural changes and demographic changes in the economy. Moreover, the central bank policymakers clearly picked up on the broad, deep and enduring social change that is occurring in the economy and country during their recent "Fed Listens" tour. One senses a shift in policy that has been influenced by demands for social justice that are clearly front and center in the economy. In its update to its Statement on Longer-Run Goals and Monetary Policy Strategy, the Fed hinted at an asymmetrical shift toward maximum sustainable employment that will favor minorities who traditionally suffer from higher unemployment than the majority demographic. This clearly will support policy organized around at targeting low and moderate income communities.

MIDDLE MARKET INSIGHT

The Fed's recent policy move sets the stage for a sustained period of low interest rates that could lead to affordable business loans and mortgages.

HOTEL OCCUPANCY DATA: IT'S ONLY HALF THE STORY



BY LAURA DIETZEL AND RYAN McANDREW

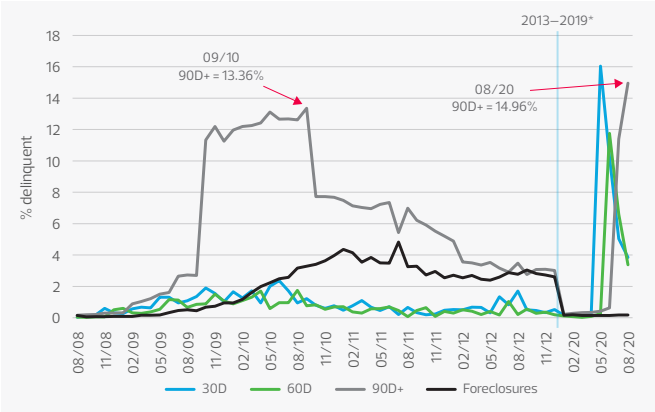
HOTEL OCCUPANCY is typically measured by the consistent supply of rooms, and on the surface recent numbers have been looking more favorable despite the continuing COVID-19 pandemic, with occupancy finally eclipsing 50%. Occupancy rates were 50.2% in the week ended Aug. 15, up from 49.9% a week earlier, and 46.2% a month earlier.

But given that the pandemic has forced closures of many U.S. hotels, and that reported occupancy rates factor in those closures, occupancy rates are not providing the full picture of distress in the industry. Meanwhile, unless hotels are given additional financial relief, more closures will ensue, artificially inflating occupancy and making it an even less reliable metric .

Total room inventory

The hospitality data firm STR has created a new data point, total-room-inventory methodology, or TRI, to factor in the temporary hotel closures. Until all temporarily closed properties have reopened, TRI will lag occupancy.

CMBS hospitality delinquencies over time



Source: Bloomberg; RSM US LLP

*periods not included

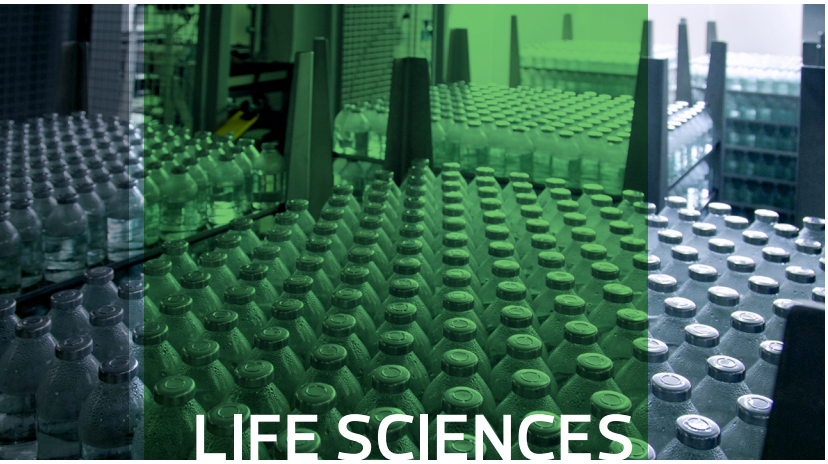
That is because room supply, its denominator, is greater than room bookings, its numerator.

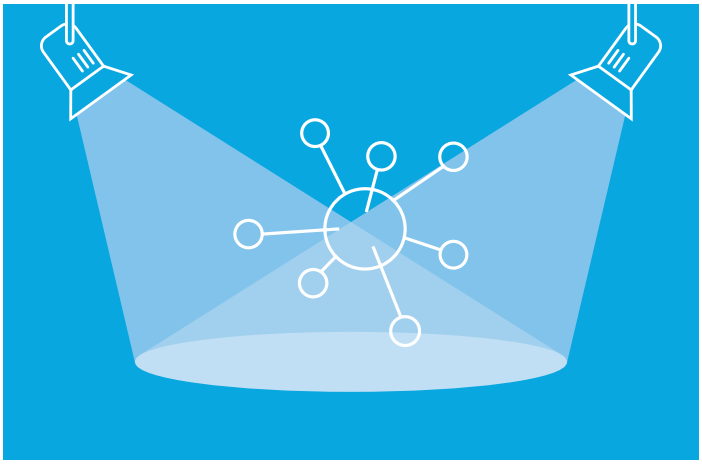
For instance, U.S. occupancy for July was 47% but TRI for the month was calculated at 44.6%, showing a 2.4% total variance in rates and a 5.2% difference.

The view on the ground offers an equally sobering perspective. Chip Rogers, chief executive of the American Hotel and Lodging Association, told Northstar Meetings Group that as many as 8,000 hotels might close by the end of September, adding, "Right now, many hotels are struggling to service their debt and keep their lights on."

Furthering the negative outlook, some 23.4% of commercial mortgage-backed security (CMBS) loans, which finance many hotels, were more than 30 days late in July, totaling $20.6 billion. To put that into context: Only 1.34% of hotel CMBS loans were in default in July 2019, according to Trepp. The highest delinquency rates relate to metro areas with a dependence on tourism and business travel, including New York City (38.7% delinquency, $1.475 billion in loans) and Chicago (53.8%, $976 million). We project that the percentage difference between traditional occupancy and TRI will continue to grow as delinquent hotels become permanent closures, further reducing the total available rooms supply in the United States.

The hospitality industry is not having the V-shaped recovery we all hoped for, as consumer demand remains dampened by the lack of a COVID-19 vaccine. The difficulties facing investors and hotel operators regarding reopening are multifaceted and complex. At the very least, a multipronged focus on safety protocols, appropriate staffing and realistic scope of demand is required to assure effective and profitable operations. ■





MORE PROMISE, MORE PROBLEMS FOR LIFE SCIENCES

Cyberattacks threaten life sciences companies researching COVID-19 vaccine

BY STEVE KEMLER, ADAM LOHR AND ANDREW WEIDENHAMER

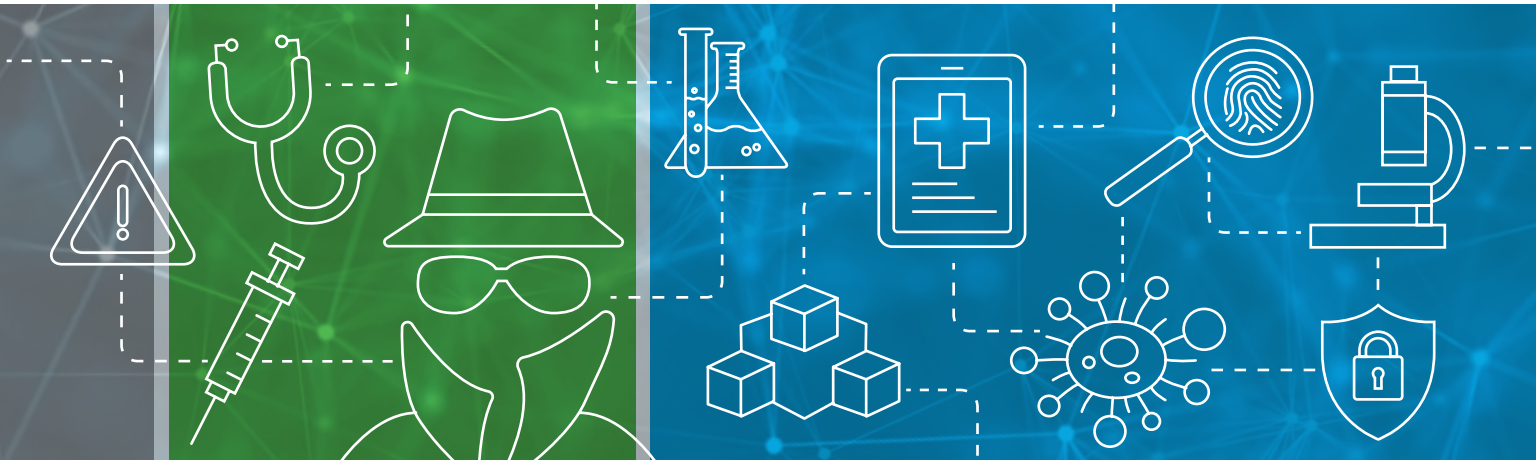
PICTURE THIS SCENARIO: Researchers at a biotech company are working tirelessly on a potential coronavirus vaccine and planning to start a phase three clinical trial soon. This work results in more visibility for the company, and an influx of capital investment. But with that greater visibility and investment comes added risk, especially in the form of cybersecurity threats from competitors and nation states looking to steal valuable intellectual property and research.

As the pandemic continues, this scenario is not a hypothetical one for companies conducting this type of work. While life sciences companies have long been a target for threat actors and have always had to guard against cyberattacks, hackers' focus on such firms has increased during the global pandemic as biotechs, pharmaceutical companies and other organizations race to develop vaccines and treatments for COVID-19. Making progress in this crucial research and embarking on clinical trials for promising drugs draws positive attention, of course, but it should also make life sciences business leaders reevaluate and address any data and cybersecurity vulnerabilities their companies might have.

Increasing threats

The origins of these types of cybersecurity threats are varied. Hackers with links to a Russian intelligence service were "trying to steal information from researchers working to produce coronavirus vaccines in the United States, Britain and Canada," The Washington Post reported July 16. A Politico article from just a few days prior said that "Canadian institutions pursuing COVID-19 research have been hacked." In April, Iran-linked hackers targeted Gilead Sciences staff, according to Reuters. In May, the FBI issued a warning to organizations researching COVID-19 of "likely targeting and network compromise" by China.

Data from the threat intelligence platform Recorded Future shows a dramatic spike in references to cyber-related attacks on biotech and pharmaceutical companies in recent months. While the number of security threats has spiked, the techniques used in these attempts to gain access to biotech companies remain unsophisticated; most start through targeted COVID-19-themed phishing emails. In the Gilead case, for instance, an Iran-based advanced threat actor group known as



MIDDLE MARKET INSIGHT

While life sciences companies have long been a target for threat actors and have always had to guard against cyberattacks, hackers' focus on such firms has increased during the global pandemic as biotechs, pharmaceutical companies and other organizations race to develop vaccines and treatments for COVID-19.

APT35 (aka, Charming Kitten) used a targeted spear phishing campaign. While the types of phishing emails vary, they typically appear to come from a legitimate group such as the World Health Organization or the U.S. Centers for Disease Control and Prevention.

Once an attacker obtains user credentials, getting access to sensitive network assets or data is often a trivial task, because users tend to reuse credentials across multiple applications and many applications lack multifactor authentication. RSM was able to demonstrate this same phishing technique during a recent penetration test of a large biotech company, resulting in access to a cloud-based laboratory information management system and the company's intellectual property. Along with phishing, ransomware also remains one of the most popular types of software threat actors use to target companies in the biotech space. 10X Genomics, a California-based biotech company researching COVID-19 treatments, was hit with a ransomware attack back in April, resulting in the compromise of employee information.

Intellectual property theft has far-reaching implications. An IP breach during a merger or acquisition, for example, might either kill such a deal completely or lower the deal valuation. Disruption resulting from an IP or clinical trial data breach will almost certainly slow down the clinical trial process.

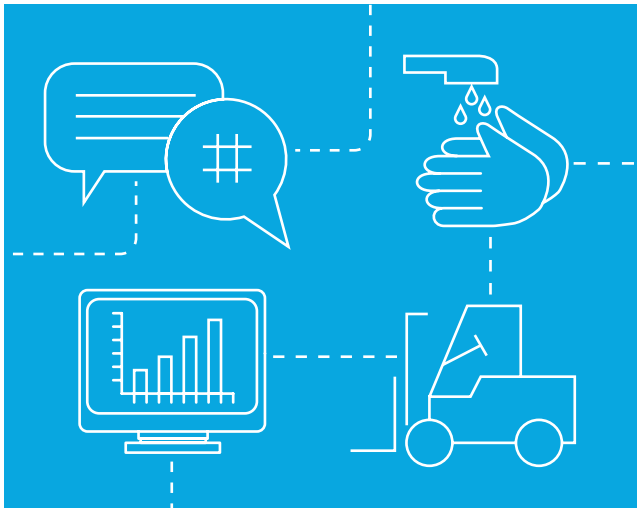
Unfortunately, most organizations in the life sciences space aren't doing nearly enough to defend against these threats, primarily because IP isn't heavily regulated and investment in information security controls is not a revenue-generating activity.

Security road map

While there is no silver bullet solution, organizations should establish and implement basic best practice information security governance and testing procedures, and periodically audit these procedures. Further, organizations should consider data protection controls such as encryption and classification. More specifically, RSM recommends that companies consider doing the following:

- Perform an information security risk assessment to identify and prioritize areas of high risk
- Conduct security testing such as external and internal penetration testing to supplement and validate results identified through the aforementioned risk assessment
- Develop a security road map that considers best practices security controls based off the results of the prior two phases

The life sciences space has a unique opportunity to drive considerable health and economic benefits during this crisis and well into the future as technology allows for more innovations. However, this is only possible if data used to achieve those results remains in the hands of those professionals using it for its intended purposes and it must be protected. ■



REOPENING CONSIDERATIONS

RSM RECENTLY ASKED executives about their reopening considerations following pandemic-related pullbacks and shutdowns. Here's how they answered some special questions in the Q3 2020 RSM US Middle Market Business Index survey.

82% said that ready access to COVID-19 testing was a consideration.

87% said they wanted to see a two-week decline in the number of COVID-19 cases requiring intensive care in the workplace location and surrounding areas.

Of those executives who said they planned to reopen a location within the next 12 months, **86%** said that it was at least somewhat important that they see a two-week decline in the number of confirmed COVID-19 cases in the workplace location and surrounding areas.

98% said that employee readiness was a consideration.

THE TAKEAWAY

As middle market companies pivot amid the pandemic's disruption, they look to state and local guidelines, health and safety considerations, customer needs, operations changes, employee readiness and more to reemerge and recover. We'll explore this topic more in an upcoming special report on middle market resiliency. Look for it later this fall.

CHECK OUT THE Q3 2020 RSM US MIDDLE MARKET BUSINESS INDEX

The third-quarter edition of the proprietary RSM US Middle Market Business Index is out now! Produced in conjunction with the U.S. Chamber of Commerce, this closely watched gauge of middle market economic sentiment, along with commentary from RSM US Chief Economist Joseph Brusuelas, provides forward-looking insights for middle market leaders. Download the full report.

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